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No. 00-157

In the Supreme Court of the United States

UNITED DOMINION INDUSTRIES, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

A "product liability loss" incurred by a corporation may be carried back a maximum of ten years from the loss year and used as a deduction in the carryback year. 26 U.S.C. 172(b)(1)(I) (1988); see 26 U.S.C. 172(b)(1)(C), (f). The question presented in this case is whether, under the Treasury regulations that govern the year in which this case arose, the availability of the "product liability loss" carryback for affiliated entities that file a consolidated return is to be determined by (i) aggregating the income and expenses of the consolidated entities or, instead, (ii) separately calculating the income and expenses of each entity.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	3
Conclusion	7

TABLE OF AUTHORITIES

Cases:

Amtel, Inc. v. *United States*, 31 Fed. Cl. (1994), aff'd, 59 F.3d 181 (Fed. Cir. 1995)	4, 5
Braxton v. *United States*, 500 U.S. 344 (1991)	8
Chrome Plate, Inc., In re, 614 F.2d 990 (5th Cir. 1980)	14-15
Gottesman & Co. v. *Commissioner*, 77 T.C. 1149 (1981)	15
H Enters. Int'l, Inc. v. *Commissioner*, 105 T.C. 71 (1995)	15
Indopco, Inc. v. *Commissioner*, 503 U.S. 79 (1992)	13
Intermet Corp. v. *Commissioner*, 209 F.3d 901 (6th Cir. 2000)	7, 13
Interstate Transit Lines v. *Commissioner*, 319 U.S. 590 (1943)	13
Moline Props. v. *Commissioner*, 319 U.S. 436 (1943)	14
United States v. *Foster Lumber Co.*, 429 U.S. 32 (1976)	9

Statutes and regulations:

Internal Revenue Code (26 U.S.C.):	
§ 11(a)	2, 15
§ 172 (1988)	2, 4, 7, 11, 12
§ 172(b)(1)(A)	9
§ 172(b)(1)(C)	4, 9
§ 172(b)(1)(f)	4

Statutes and regulations—Continued: Page

§ 172(b)(i)(I) (1988) 4, 9, 10
§ 172(c) 8
§ 172(f) 4, 14
§ 172(f)(1)(A) 9
§ 172(j) 15
§ 172(j)(1) 9
§ 172(j)(2) 9
§ 1501 ..... 2, 3, 7, 8
§ 1502 ..... 2, 3, 5, 7, 8, 10
§ 1503 ..... 8, 10
§ 1504(a) 10
§ 7701(a)(1) 10
§ 7701(a)(14) 10
Treas. Reg. (26 C.F.R.):
Section 1.1502 (1988) 2
Section 1.1502-1(e) 4
Section 1.1502-11 (1986) 10
Section 1.1502-12 (1986) 3, 11
Section 1.1502-21(a) (1986) 11
Section 1.1502-21(b) (1986) 12
Section 1.1502-21(f) (1986) 12, 13
Section 1.1502-80(a) 14, 15

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BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-24a) is reported at 208 F.3d 452. The opinion of the district court (Pet. App. 25a-41a) is unofficially reported at 98-2 U.S. Tax Cas. (CCH) ¶ 50,527.

JURISDICTION

The judgment of the court of appeals was entered on March 24, 2000. The petition for rehearing and for rehearing en banc was denied on May 19, 2000 (Pet. App. 42a). The petition for a writ of certiorari was filed on July 28, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

1. The applicable provisions of Section 172 of the Internal Revenue Code, 26 U.S.C. 172 (1988), and of the regulations that govern the filing of consolidated returns, 26 C.F.R. 1.1502 (1986), are set forth at Pet. 1-3 and Pet. App. 43a-59a.

2. 26 U.S.C. 11(a) provides:

> A tax is hereby imposed for each taxable year on the taxable income of every corporation.

3. 26 U.S.C. 1501 provides, in relevant part:

> An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. * * *

4. 26 U.S.C. 1502 provides:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability

and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

STATEMENT

1. Petitioner is the successor in interest of the common parent of an affiliated group of corporations that filed consolidated federal income tax returns for the taxable years 1983-1986. Pet. App. 3a. By filing a consolidated return, these corporations "consent[ed] to all the consolidated return regulations prescribed under section 1502 [of the Internal Revenue Code] prior to the last day prescribed by law for the filing of such return." 26 U.S.C. 1501. The statute broadly authorizes the Secretary to adopt such consolidated return regulations as he "may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group * * * may be returned, determined, computed, assessed, collected, and adjusted, in such manner as clearly to reflect the income tax liability * * * and in order to prevent avoidance of such tax liability." 26 U.S.C. 1502.

The affiliated corporations that joined in the consolidated return included Jesco, Inc., Cherry-Burrell Corporation, Amtel, Inc., The Litwin Corporation and Litwin Panamerican Corporation. Pet. App. 3a. Petitioner reported consolidated net operating losses for each of the years from 1983 to 1986. While all of the affiliates named above incurred product liability expenses in each of those years, either some or all of them had a positive "separate taxable income" (under 26 C.F.R. 1.1502-12) during those years. Pet. App. 27a. The issue in this case is whether the product liability expenses incurred by the affiliates that had positive

separate income during these years constitute "product liability losses" under 26 U.S.C. 172(b)(1)(I) (1988) that may be carried back ten years and used as deductions from petitioner's consolidated taxable income for the taxable years 1973-1976.[1] The Internal Revenue Service determined that the product liability deductions claimed by the affiliates during the years that they had positive separate taxable incomes did not constitute "product liability losses" for purposes of Section 172 that could be carried back for the ten-year period authorized by that statute. Pet. App. 28a. The Service therefore denied petitioner's refund claims for the 1973-1976 consolidated return years. *Ibid.*

2. Petitioner thereafter brought a refund suit in the United States Court of Federal Claims, asserting that the product liability deductions claimed by its affiliates during 1985 created a product liability loss that could be carried back ten years and deducted from the gross income reported on their consolidated return for 1975. In that case, petitioner contended that the Amtel group was entitled to the carryback on the theory that "a consolidated group is treated as a single entity with respect to the product liability provisions." *Amtel, Inc.* v. *United States*, 31 Fed. Cl. 598, 599 (1994), aff'd, 59 F.3d 181 (Fed. Cir. 1995).[2] The Court of Federal Claims

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[1] The provisions formerly located at Section 172(b)(1)(I) have been relocated at Section 172(b)(1)(C), (f). See 26 U.S.C. 172(b)(1)(C), (f).

[2] In 1975, Amtel was the common parent of an affiliated group of corporations that included Litwin and Panamerican. Those corporations were not members of petitioner's affiliated group in that year. The consolidated return regulations accompanying Section 1502 of the Code denominate the 1975 taxable year a "separate return year" for Amtel, Litwin and Panamerican. See 26 C.F.R. 1.1502-1(e).

held, however, that "Amtel cannot carry back a product liability loss from 1985 to 1975 because it had no net operating loss in 1985." 31 Fed. Cl. at 600. The court noted that, under the governing consolidated return regulations (26 C.F.R. 1.1502-79(a)(3)), Amtel had no separate loss for 1985 to carry back to its 1975 separate return year. 31 Fed. Cl. at 601. The court rejected the argument that a "consolidated product liability loss" should be computed for petitioner for 1985 because the consolidated return "regulations do not use the term 'consolidated product liability loss' or incorporate such a concept by directing that product liability loss be treated on a consolidated basis." 31 Fed. Cl. at 602. The Federal Circuit affirmed the decision of the Court of Federal Claims in an unpublished opinion. 59 F.3d 181 (1995) (Table).

3. After the Federal Circuit issued its opinion in *Amtel*, petitioner filed this second refund suit in the United States District Court for the Western District of North Carolina, again contending that product liability deductions claimed by its affiliates during 1983, 1984, 1985 and 1986 created product liability losses that could be carried back ten years and deducted from petitioner's consolidated taxable income for 1973, 1974, 1975 and 1976. Pet. App. 28a. The complaint sought a refund of $1,618,305 plus statutory interest. J.A. 15.

The district court granted petitioner's motion for summary judgment. Pet. App. 25a-41a. The court agreed with petitioner that an affiliated group's product liability loss carryback should be determined on a consolidated basis. *Id.* at 38a-39.[3]

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[3] The district court also held that the decision in *Amtel* did not collaterally estop petitioner from asserting that product liability losses must be accounted for on a consolidated basis. Pet. App.

4. The court of appeals reversed. Pet. App. 1a-23a. The court concluded that the consolidated return regulations "make clear * * * that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated 'product liability loss' is not intended." *Id.* at 16a. The court observed that, under the consolidated return regulations, "product liability expenses are linked to the consolidated net operating loss only through their nexus to the group member" (*ibid.*) and "that an interpretation removing the close nexus between such expenses and whether the affected company operated at a loss is inconsistent with the regulations." *Id.* at 17a. The court concluded "that determining 'product liability loss' separately for each group member is correct and consistent with the regulations." *Ibid.* The court explained the proper method for determining product liability loss on a consolidated return (*id.* at 21a):

> The regulations governing consolidated returns provide a simple and direct method for determining the portion of a group member's product liability expenses that are "product liability loss." The regulations define a group member's "separate net operating loss," *see* Treas. Reg. § 1.1502-79(a)(3), which is analogous to an individual's "net operating loss" on a separate return. By comparing each member's product liability expenses to its "separate net operating loss," that member's "product liability loss" may be properly calculated. The parent's "product liability loss" is then calculated as the total of the members' "product liability loss."

39a-40a. The United States did not raise the collateral estoppel issue in the court of appeals.

ARGUMENT

1. The court of appeals correctly concluded that petitioner is not entitled to use product liability expenses incurred by a profitable affiliate to generate "product liability losses" that may be carried back for the ten-year period authorized by Section 172 of the Internal Revenue Code, 26 U.S.C. 172. The Sixth Circuit, however, incorrectly reached the opposite conclusion in its recent decision in *Intermet Corporation* v. *Commissioner*, 209 F.3d 901 (2000). There is thus a conflict among the circuits on a matter of substantial recurring importance in tax administration.

Under Section 1501 of the Code, the Treasury has the authority and responsibility to adopt consolidated return regulations that, when adopted, would effect a binding resolution of this matter. Section 1501 specifies that affiliated corporations may file a consolidated return only "upon the condition that * * * the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return." 26 U.S.C. 1501. In turn, Section 1502 authorizes the Secretary to "prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group" be properly determined "in such manner as clearly to reflect the income tax liability" of those entities. 26 U.S.C. 1502. Congress has thus vested ample authority in the Secretary to adopt binding regulations to govern the treatment of consolidated returns. Once such binding regulations are adopted, any taxpayer who files a consolidated turn "shall be considered" as having consented to them. 26 U.S.C. 1501.

When, as in this case, an agency has been directed to resolve controversial applications of a statute by regulation, this Court has stated that it is "more restrained and circumspect in using [the] certiorari power as the primary means of resolving [circuit] conflicts." *Braxton* v. *United States*, 500 U.S. 344, 348 (1991). Nonetheless, the regulations adopted by the Secretary under Section 1502 are binding on taxpayers only if they are in effect "prior to the last day prescribed by law for the filing" of the taxpayer's consolidated return. 26 U.S.C. 1501.[4] Accordingly, while the Secretary remains fully empowered to resolve the existing controversy prospectively, it appears that only this Court could now resolve the existing conflict among the circuits for past years.

The Internal Revenue Service advises us that the question presented in this case is currently pending in more than 100 cases at the administrative level. Moreover, for all years that precede any prospective administrative clarification of the governing regulations—a clarification that is now only at the earliest stages of consideration—the question presented here is likely to arise in numerous cases. In this situation, we do not oppose the grant of certiorari in this case.

2. a. A "net operating loss" is defined as "the excess of the deductions * * * over the gross income" of the taxpayer. 26 U.S.C. 172(c).[5] "A taxpayer does not have

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[4] See also 26 U.S.C. 1503 (whenever a consolidated return is filed, "the tax shall be determined * * * in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of such return").

[5] Unless otherwise noted, the statutory references in this brief are to the Internal Revenue Code as in effect between 1983 and 1986.

a [net operating] loss for a particular year unless its deductions exceed its ordinary income and its capital gains." *United States* v. *Foster Lumber Co.*, 429 U.S. 32, 47 (1976). Under Section 172 of the Code, a taxpayer is generally allowed to carry back net operating losses for three years from the year in which the loss was incurred. 26 U.S.C. 172(b)(1)(A). Section 172(b)(1)(I) of the Code, however, provides an exception from the general rule that allows "product liability losses" to be carried back for a period of ten years. 26 U.S.C. 172(b)(1)(I).[6] The term "product liability loss" is defined to mean "the lesser of" the "net operating loss for such year" and the deductible expenses incurred by the entity that are "attributable to" the satisfaction or defense of product liability claims. 26 U.S.C. 172(j)(1).[7] A taxpayer thus has a "product liability loss" for a particular taxable year only if (i) the taxpayer has a net operating loss for the year (*i.e.*, its total deductions exceed its gross income) *and* (ii) the net operating loss is attributable in whole or in part to deductions for product liability expenses.[8]

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[6] The ten-year carryback period for product liability losses is now provided by Sections 172(b)(1)(C) and 172(f)(1)(A) of the Code. 26 U.S.C. 172(b)(1)(C), (f)(1)(A) (1994 Supp.).

[7] The term "product liability" is defined as (26 U.S.C. 172(j)(2)):

> liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if * * * such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

[8] The Internal Revenue Code generally defines a "taxpayer" as "an individual, a trust, estate, partnership, association, com-

b. This case concerns the proper application of the product liability loss provisions to an affiliated group of corporations that files a consolidated return. When an affiliated group of corporations files a consolidated return, "the tax shall be determined, computed, assessed, collected, and adjusted in accordance with the regulations under section 1502 prescribed before the last day prescribed by law for the filing of such return." 26 U.S.C. 1503. The consolidated return regulations promulgated by the Treasury pursuant to Section 1502 are designed to arrive at a single figure of income or loss for the affiliated group for the consolidated return year. This figure, which is denominated "consolidated taxable income" under the regulations, is determined by taking into account the "separate taxable income" of each member of the affiliated group. 26 C.F.R. 1.1502-11 (1986). Subject to specific exceptions, the regulations provide that "[t]he separate taxable income of a member * * * is

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pany, or corporation." 26 U.S.C. 7701(a)(1) and (14). Section 7701(a)(1) provides that "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—[t]he term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." Section 7701(a)(14) provides that "[t]he term 'taxpayer' means any person subject to any internal revenue tax." An affiliated group of corporations that files a consolidated return is generally not treated as a "taxpayer" for purposes of the Internal Revenue Code because an affiliated group is defined as "1 or more chains of includible corporations connected through stock ownership with a common parent corporation, which is an includible corporation * * *." 26 U.S.C. 1504(a). Thus, the "taxpayer" referred to in Section 172(b)(1)(I) is a corporation that files a separate return, reports a net operating loss, and claims product liability deductions; the term does not encompass an affiliated group of corporations.

computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporations * * *." 26 C.F.R. 1.1502-12 (1986).[9] The "net operating loss deduction" available for the consolidated entity is thus determined in the same manner as the group's consolidated taxable income: each member of the group computes its separate taxable income or loss and, with specific adjustments, these separate figures are then aggregated into a single figure constituting the consolidated taxable income.[10] If

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[9] The "separate taxable income" computed by a member of an affiliated group is not necessarily equivalent to the income or net operating loss figure that the corporation would have computed had it filed a separate return. It is possible for a corporation to compute positive separate taxable income even though the corporation would have reported a net operating loss had it filed a separate return. For example, if a corporation made a charitable contribution during a particular year, it could conceivably have had a "net operating loss" under Section 172 even though it computed positive separate taxable income under the consolidated return regulations, because the charitable contributions deduction is not taken into account in the computation of separate taxable income. Conversely, it is possible for a corporation to compute negative separate taxable income even though it would have reported positive income had it filed a separate return. Nothing in the record of this case, however, suggests that any member of petitioner's affiliated group that computed positive separate taxable income and claimed product liability deductions would have had a "net operating loss" under Section 172 had it filed a separate return.

[10] Under the regulations, the "net operating loss deduction" available for the consolidated entity is defined as "an amount equal to the aggregate of the consolidated net operating loss carryovers and carrybacks to the taxable year (as determined under paragraph (b) of this section)." 26 C.F.R. 1.1502-21(a) (1986). In turn, paragraph (b) provides that "[t]he consolidated net operating loss carryovers and carrybacks to the taxable year shall consist of any consolidated net operating losses (as determined under paragraph

a consolidated net operating loss results from these calculations, it may then be carried back (or forward) under Section 172 to other taxable years for which the affiliated group reported taxable income.

c. Petitioner errs in claiming that an affiliated group that reports a consolidated net operating loss for a particular year necessarily has a product liability loss for the year equal to the sum of the product liability expense deductions claimed by its members. See Pet. App. 11a. Under the regulations described above, each group member must initially compute its product liability loss (if any) on an individual basis, and the resulting figures are then to be aggregated to arrive at the total loss for the group.[11] The court of appeals correctly held (Pet. App. 17a) that petitioner's contrary approach is at odds with these regulations.

In particular, the consolidated return regulations require the consolidated net operating loss deduction to be computed by aggregating the separate taxable income of each of the affiliates. 26 C.F.R. 1.1502-21(f) (1986). The individual members of the group are initially to compute their "separate taxable incomes," those figures are to be aggregated into a single amount, and this amount is then adjusted by taking into account

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(f) of this section) of the group, plus any net operating losses sustained by members of the group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b)." 26 C.F.R. 1.1502-21(b) (1986). And, in turn, paragraph (f) provides that "the consolidated net operating loss shall be determined by taking into account * * * [t]he separate taxable income * * * of each member of the group * * *." 26 C.F.R. 1.1502-21(f) (1986).

[11] Petitioner is simply wrong in suggesting that "the IRS itself has favored single-entity treatment in the past" (Pet. 14). In fact, the Service has never endorsed that approach.

the consolidated items delineated in the regulation. *Ibid.* The consolidated items listed in the regulation do *not* include deductions attributable to product liability expenses. See *ibid.* Deductions for product liability expenses therefore must be applied in the first instance against the gross income of each affiliate in computing its "separate taxable income" under the regulations. Because the deductions are applied against the income of the individual affiliates, they cannot be treated separately from the corporation that claimed them. As the court of appeals correctly concluded, the requirement of the consolidated return regulations that a "separate taxable income" be computed for each affiliate "makes clear that blending those expenses is not permitted, i.e., that a comparison of the group members' aggregated product liability expenses to the consolidated net operating losses in order to derive a consolidated 'product liability loss' is not intended." Pet. App. 16a. The court of appeals properly rejected petitioner's claim in this case, for petitioner failed to sustain its "burden of clearly showing the right to the claimed deduction" under the regulations. *Indopco, Inc.* v. *Commissioner*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943)).[12]

3. In *Intermet Corporation* v. *Commissioner*, *supra*, the Sixth Circuit resolved the question presented in this case in favor of the taxpayer. Pet. App. 60a-76a.

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[12] Petitioner's criticism of the court's method of computing the "product liability loss" for specific individual members of the affiliated group (Pet. 12) is irrelevant to the legal issue presented in this case. There is no evidence in the record that any individual member of petitioner's affiliated group would have a "product liability loss" under any method of calculating such a loss at the individual level. See note 9, *supra*.

Although the court stated in *Intermet* that the consolidated return "regulations do not specifically address the application of the [loss] carryback" (*id.* at 67a), the court ultimately concluded that this issue was properly resolved by a portion of the regulations that neither party had cited. That regulation is 26 C.F.R. 1.1502-80(a), which specifies that "[t]he Internal Revenue Code, or other law, shall be applicable to the [consolidated] group to the extent the regulations do not exclude its application." The court stated that this regulation requires an affiliated group of corporations to be treated as a single taxpayer for purposes of the Internal Revenue Code unless the consolidated return regulations mandate a different result. Pet. App. 69a. The court in *Intermet* reasoned that, because the consolidated return regulations mandate no specific result in this situation, the entire affiliated group must be treated as a single "taxpayer" for purposes of Section 172(f). Pet. App. 69a. The court concluded that nothing in the regulations modified "the default rule" in 26 C.F.R. 1.1502-80(a) under which the consolidated group was to be treated as if it were a single taxpayer. Pet. App. 74a.

The Sixth Circuit erred in its construction of this regulation, which simply specifies that the usual rules found in the Internal Revenue Code or other sources of law apply to an affiliated group of corporations unless the consolidated return regulations provide a different rule. 26 C.F.R. 1.1502-80(a). The relevant "default" rule thereby incorporated into the consolidated return regulations is that every separate corporation is to be treated as a separate taxable entity (unless the consolidated return regulations otherwise provide). See 26 U.S.C. 11(a); *Moline Properties* v. *Commissioner*, 319 U.S. 436, 439-440 (1943); *In re Chrome*

Plate, Inc., 614 F.2d 990, 996 (5th Cir. 1980). The "default" rule provided by the regulation thus requires members of an affiliated group to be treated as *separate* entities when applying provisions of the Internal Revenue Code *unless* the consolidated return regulations provide for treatment of the group as a single entity. See *Gottesman & Co.* v. *Commissioner*, 77 T.C. 1149, 1156 (1981); *H Enterprises International, Inc.* v. *Commissioner*, 105 T.C. 71, 85 (1995). The court of appeals erred in *Intermet* by giving the regulation an interpretation that simply stands its plain text upside down.

There is, as we have noted, no evidence in the record of this case that any member of petitioner's affiliated group would have had a product liability loss under Section 172(j) if it had filed a separate return during the years in issue. See note 12, *supra*. Applying the "default" rule of 26 C.F.R. 1.1502-80(a) to this case therefore requires rejection, rather than acceptance, of petitioner's claim.

CONCLUSION

For the reasons stated above, the United States does not oppose the granting of the petition for a writ of certiorari.

Respectfully submitted.

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